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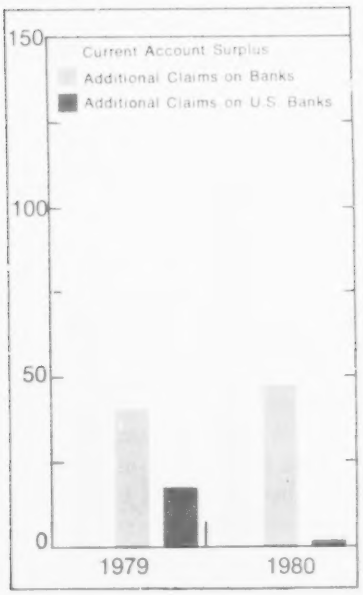
What OPEC is Doing With Its Money

Sufficient data are now available to give a relatively complete picture of how the OPEC countries disposed of the huge $110-billion current-account surplus they accumulated last year. Some $44-$45 billion flowed into deposits with the banking systems of the industrialized countries. Other investments in the industrialized nations—chiefly purchases of government bonds and bills, private-sector debt, and equities—accounted for an additional $33 billion, of which $15 billion represents investments in the United States or claims against non-bank U.S. entities. Some $5 billion was loaned directly on a term basis to the oil-importing developing nations. Another $5 billion was invested in the debt of international organizations. And approximately $15 billion was accounted for by short-term credits for oil exports. When account is taken of foreign borrowing, the unidentified residual would thus appear to fall in the $10-$15 billion range.

The disposition of the OPEC surplus

billion dollars



There are several features of this pattern of deployment of the OPEC surplus that deserve mention. One is the decline in the proportion of new assets held in the form of bank deposits. In 1979, almost two-thirds of the identifiable additions to OPEC portfolios took this form. Last year this fraction was down to one-half. This pattern of increased diversification as to type of asset closely parallels the events following the first oil price shock, and can be expected to continue.

The most striking development, however, has been the decline in the proportion of OPEC assets held in the form of claims against the U.S. banking system. From the end of 1979 to the end of 1980, the liabilities to OPEC countries of banks in the United States plus major foreign branches of U.S. banks increased by only $1.1 billion, less than 3% of the total increase in OPEC claims against banks in the industrialized countries. The liabilities of the U.S. banking system to Middle East oil exporters actually declined $2.0 billion last year. This is a sharp reversal from 1979, when $16.5 billion of the nearly $40-billion increase in OPEC claims against the international banking system was held with U.S. banks. Although comprehensive data are lacking, this change in OPEC asset preferences does not appear to represent a diminished attraction of dollar-denominated assets, however. Indeed, it would appear that the trend toward diversification away from dollar assets in OPEC portfolios so noticeable in 1978 and 1979 was sharply reduced if not reversed last year.

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Canadian real economic growth forecasts revised up.

Latest economic indicators point to a faster pace of Canadian real GNP growth in 1981 than previously forecast. Late last year, the rate of real GNP expansion was projected at 1.0%-1.5%, but most forecasts for 1981 have now been lifted to 3%-3.5%. Reasons include the fast rate of U.S. growth in the first quarter, indications of increased investment spending by Canadian businesses, reasonably good export prospects, and inventory rebuilding in the wake of last year's economic decline. Faster growth, however, is being accompanied by higher inflation, as consumer prices advanced at a 12.5% annual pace in March. Also, Canadian interest rates have climbed in response to higher U.S. rates. These influences suggest that the economy will not sustain vigorous growth throughout the year, but will likely evince quarterly volatility.

Economic activity turns up in Germany, but the cause is still uncertain.

Recent data suggest an upturn in German economic activity. Industrial production rose a provisional 4.5% in February, after advancing 1.8% in January, and February industrial-order volume was up 5.8% above its yearend-1980 level. The gain in order volume came almost exclusively from the export sector, as foreign orders grew some 10% in the first two months of 1981, while domestic orders grew only 2%. The rebasing of the industrial production index in January calls for caution in the interpretation of production figures. But trade deficits in January and March—the product of an import surge—are consistent with stronger economic activity. Sufficient data are not yet available, however, either to confirm the upswing or identify its origins. But several hypotheses may explain the upturn: inventory liquidation may have ended; the personal savings ratio may have fallen; or export demand (especially from OPEC) may have surged. The first two elements would be unlikely to lead to a lasting economic recovery, but a surge in export demand would not only spur recovery, it would also narrow Germany's large current-account gap and permit the central bank to lower interest rates gradually.

Italian economic strength continuing, but weakness threatens.

The Italian economy continues to exhibit remarkable strength. Recently released data show that real GDP rose at a seasonally adjusted rate of 2% in the final quarter of last year, following a 2.7% decline in the third quarter. Moreover, Italy's volatile industrial production index posted a seasonally adjusted 7.5% rise in February after a small drop in January. Trade and inflation figures have confirmed the strength in demand; consumer prices rose at an annual rate of 20% in the first quarter, and trade deficits of 1.5 trillion lira were recorded in each of the first two months of 1981. The economy is expected to slow down in the near future, however, in response to credit restrictions imposed in February and the rise in the discount rate to a record 19%, which accompanied the March devaluation of the lira. If the economy fails to cool down, another increase in Italian interest rates can hardly be avoided.

Irish economic deterioration prompts rumors of imminent general election.

The Irish economy appears to be quickly departing from the course planned for it by the present government. Only three months into the current financial year, and already the budget deficit on current account amounts to some 205 million pounds, as against a target of 515 million pounds for the full year. Public-sector borrowing now threatens to reach 18% of GNP, an all-time record proportion. Inflation has begun to accelerate anew, as confirmed by the huge 2.8% jump in wholesale prices in January. And Ireland is faced with a substantial balance-of-payments shortfall, with the March trade deficit double that of March 1980. Deflation might seem the obvious remedy, but industrial output is already well below last year and unemployment is high and rising. Moreover, the present government was elected in 1977 on the strength of promises to foster a fast and sustained economic growth rate, and it is unwilling to impose deflationary measures. It is clear, however, that some policy changes must be introduced soon. This has prompted widespread speculation that the government will seek reelection shortly and that—if reelected for another five-year term—it will launch a new term with a heavy dose of deflation.

Honduran economic growth contracted sharply last year.

The Honduran economy has not been immune to the recent turmoil elsewhere in Central America, as evidenced by its economic performance last year. A decline in private-sector investment was a major contributor to the deceleration of economic growth to 2% in 1980, which compares with annual average growth of 7.5% in the 1975-79 period. Most of the deterioration was concentrated in construction, manufacturing, and agriculture. In the agricultural area, coffee output dropped about 15%, owing to cyclical forces, while banana output declined approximately 4% because of work interruptions. Since these commodities account for more than half of foreign-exchange earnings, the country's external-payments position was adversely affected. Total exports rose by only 8%, while imports advanced 22%. As a result, the trade deficit—which averaged $100 million in 1978 and 1979—widened to $250 million. This, coupled with a sizable volume of capital flight, led to a reduction in official reserves to $150 million as of end-1980, compared with reserves of $210 million at end-1979.

Economic rebound seen for Hong Kong in second half of 1981.

Export-oriented manufacturers in Hong Kong are troubled by high interest rates and weakness in sales. The high rates have also cooled the property market boom, which has been the second major prop of the economy. With a dearth of encouraging economic developments in recent months, investors' moods have distinctly changed. As a result, Hong Kong's balance-of-payments position has deteriorated. The ensuing exchange-rate weakness has pushed up the annualized rate of inflation to more than 20%. However, all is not lost for 1981. Exporters are expecting strong Christmas shipments, and property developers are anticipating a turnaround in the second half of the year, barring unforeseen adverse political developments. The impending rebound is expected to bring with it a stronger exchange rate and a lower rate of inflation, setting the stage for vigorous growth in 1982.

Sri Lankan progress on budget control in 1981 derailed by added spending.

In an effort to reduce a swollen budget deficit, Sri Lankan authorities implemented in November 1980 cuts of 25% from pre-budget estimates of 1981 capital expenditures. The overall budget deficit for 1981 was then projected at 11.8 billion rupees (about $655 million), and was to be financed entirely through foreign funding and non-inflationary domestic borrowing. No supplemental expenditures were to be permitted. In March, however, the authorities restored funds cut from a water-supply project and some 750 million rupees for the Mahaweli Ganga Development Program. To offset these added appropriations, all other ministries were instructed to cut spending by 10% over and above the November 1980 reductions. Still, the anticipated budget deficit has increased to 12.9 billion rupees—equal to about 15% of forecast GDP—and central bank borrowing of approximately 3 billion rupees will be needed. Although the forecast gap in 1981 is narrower than the 14-billion-rupee deficit of 1980, the government's failure to adhere to its original budget figures by making adequate offsetting cuts demonstrates that it faces an uphill battle in its effort to rein in the budget deficit.

Market fundamentals suggest sugar price rise.

Current world sugar prices of approximately 15 cents per pound are a puzzle to some analysts because they do not reflect market fundamentals. The 1980-81 world sugar crop is expected to be near 87 million metric tons, while consumption is projected at more than 89 million metric tons. This will leave global sugar stocks at the end of crop year 1980-81 (August) at about 21 million tons, reducing the ending-stocks-to-consumption ratio to almost 24% from 26.3% in 1979-80. The last time this ratio was this low—in 1974—prices reached a monthly average of almost 60 cents per pound in November. Possible explanations for the current relatively low price levels are high interest rates, the dollar's strength, and retrenchment by speculators. It has been suggested, however, that U.S. Department of Agriculture estimates of consumption may be on the high side, and that fructose maize syrups may be making greater inroads into sugar consumption. Yet, based on actual market fundamentals of supply and demand, sugar prices would appear likely to be headed higher.

Shaping a Farm Policy for the 1980s

Despite President Reagan's lifting of the Soviet grain embargo last month, little support for administration agricultural policy is evident among Congressional farm policymakers. The President has proposed a major departure from past legislation for the omnibus farm bill that will replace the Food and Agriculture Act of 1977, set to expire September 30. To minimize federal budget exposure and help keep U.S. farm prices competitive in world markets, Mr. Reagan favors ending current support programs of target crop prices and deficiency payments to farmers. Instead, he has recommended what is described as a more market-oriented approach that makes greater use of agricultural loans and systems of crop reserves to provide a "safety-net" for farmers in times of excess production.

Agriculture committees in both the House and the Senate initially balked at the idea of eliminating agricultural subsidies. They essentially scrapped the Administration's proposal and voted to extend potentially expensive support programs the President had sought to do away with. Both committees are due to conclude work on the bill this Friday. However, the final form of the farm legislation—and thus the blueprint of farm policy for the first half of the 1980s—is still uncertain.

The changes in American agriculture and in economic and political conditions that have occurred over the past decade suggest that the 1981 farm act may well turn out substantially different from past policy. Historically, farm programs have been directed mainly at enhancing price and income stability in the agricultural sector and increasing the incomes of farm families.

When the 1977 Act was passed, U.S. farmers were still reeling from a dramatic reversal in their incomes. Net farm income had dwindled to $18 billion from its peak of $33 billion in 1973, and there were strong pressures to reinstate government programs to support incomes through higher commodity prices.

The importance of income support today, relative to other farm policy issues, however, has been greatly diminished—although income volatility remains a problem. A key reason is the marked overall improvement in real and relative incomes of the farm population—primarily the result of expanded overseas markets and greater reliance by smaller farmers on nonfarm sources of income. Moreover, government farm income support is now all the more untenable in light of efforts to curb inflation, contain the federal budget deficit, minimize government intrusion in agricultural markets, and in view of the greater concern with keeping U.S. farm prices internationally competitive. In this climate, some version of the Administration's proposal seems likely to survive the legislative process.

Interest Rate Volatility to Continue

The Federal Reserve's discount rate hike last week seems to indicate an increased willingness on its part to respond to what it perceives as excessive money growth. Estimating the precise effect recent Fed actions will have on money market rates in the near term is difficult, however, apart from how the money supply behaves. It is unclear what the Fed's current targets for various measures of reserves are. And even if these targets were known, empirical evidence suggests that any estimate of the federal funds rate consistent with the reserves targets and the new discount rate is subject to considerable error.

Last Monday, the Federal Reserve increased its basic discount rate to a record 14% from 13%. It also raised the penalty surcharge for large banks at the discount window to four from three percentage points.

In a recent Federal Reserve study on the new monetary control procedures, Fed economists noted that the Fed usually does not alter its nonborrowed reserves target in response to a rise in the discount rate. They note that, as a result, the federal funds rate tends to be bid up over recent levels by roughly the rise in the discount rate. They also present empirical evidence suggesting that a 100-basis point increase in the penalty surcharge has been associated with a slightly smaller rise in the funds rate. Thus, other things equal, the recent discount rate move would be consistent with a rise in the average funds rate of a little less than 200 basis points over the recent weeks' average—or to around 18%.

Other things may not be equal, however. The recent surge in money growth has caused required reserves to grow more rapidly. If the Fed's nonborrowed reserves target has not changed, then the demand for reserves will rise relative to this targeted supply of nonborrowed reserves. If this target is adhered to (which it often is not), the expected result would be a rise in the funds rate relative to the discount rate, and increased discount-window borrowing.

However, the relationships among the volume of discount-window borrowing, the funds rate, the discount rate, and the penalty surcharge are not stable in the near term. In fact, these relationships have become more variable since the implementation of the current reserves-targeting strategy. Fed economists note that the variability in these relationships "adds to the market's difficulty in tracking the Federal Reserve's policy posture" and "contributes to the short-run volatility of interest rates." This, combined with the lack of information the market has regarding the Fed's reserves target, makes it difficult to predict the near-term funds rate even if the behavior of the money supply were known. And given the inherent variability of the money supply and the sensitivity of money-market rates to unexpected money growth, it appears likely that rates will continue to be volatile in the near term.

Africa and Middle East

Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS: 6 months ending	EXPORTS: change from year earlier	GNP IN 1980: in billions of dollars	GNP IN 1980: per capita	BALANCE OF PAYMENTS: latest data	BALANCE OF PAYMENTS: reserves (less gold) in million $	BALANCE OF PAYMENTS: 12-month change	BALANCE OF PAYMENTS: months of imports covered	BALANCE OF PAYMENTS: use of IMF credit, millions of dollars	BALANCE OF PAYMENTS: current influences on payments	MONEY AND BANKING: 12-month changes: latest data	MONEY AND BANKING: 12-month changes: consumer prices	MONEY AND BANKING: 12-month changes: latest data	MONEY AND BANKING: 12-month changes: money supply(M1)	MONEY AND BANKING: exchange rate in U.S. dollars, May 6, 1981	MONEY AND BANKING: change from year earlier	MONEY AND BANKING: current monetary conditions	COUNTRIES
Africa	Algeria	Public-sector spending on telecommunications and infrastructure projects continues to rise.	Jan.	+ 27%	29.0*	$1,525	Mar.	3,503	+ 15%	4.0	0	Agreement reached with Belgium on LNG export price of $4 per million BTUs.	Dec. '79	+ 12%	Oct.	+ 19%	.2425	— 7%	Central bank foreign assets in Sept. up 39% from end-'79.	Algeria
	Angola	Lobito port to boost cargo-handling capacity 68%; Benguela Railway still virtually inoperative.	Dec.	+ 108%	3.6	500	n. a.	—	—	—	—	U.S. and Brazil oil firms step up search; Gulf Oil plans $100-mn. investment.	n. a.	—	—	—	n. a.	—	Foreign-exchange reserves rose sharply last year.	Angola
	Botswana	Agricultural output bolstered by above-normal rains, but need for grain imports remains.	Dec.	+ 20%	0.7	850	Mar.	331	+ 20%	8.6	0	Higher imports and stagnant exports suggest wider current-account gap.	Aug.	+ 11%	Jan.	+ 22%	1.40	+ 10%	Public-sector spending on strong uptrend.	Botswana
	Egypt	President announces planned rise in basic subsidies and 25% increase in minimum monthly wage.	Oct.	+ 53%	16.4*	400	Dec.	1,046	+ 98%	3.0	144	Crude export prices cut by between $0.50-$3 per barrel.	Nov.	+ 19%	Nov.	+ 24%	1.45	+ 1%	Growth of bank claims on government slows.	Egypt
	Liberia	Business confidence appears to be returning; nationalizations ruled out.	Dec.	— 1%	0.7	380	Feb.	15	— 70%	0.3	58	Rubber export earnings suffer reduced volume and prices.	May '80	+ 16%	Dec.	+ 15%	Par	—	IMF credits bolster foreign reserves.	Liberia
	Madagascar	Despite cut in expenditures, 1981 budget projects substantial deficit.	July	+ 39%	2.7	310	May '80	9	— 80%	0.1	50	Imports to be cut 20%; capital outflows temporarily suspended.	Oct.	+ 20%	Dec.	+ 23%	.0042	— 12%	Foreign debt service excessively high.	Madagascar
	Malawi	Favorable growing conditions could yield positive GDP growth, despite lower development spending.	Dec.	+ 23%	1.5	250	Mar.	48	+ 38%	1.3	59	Early tobacco sales show unexpected price strength.	Jan.	+ 17%	Feb.	+ 7%	1.1650	— 6%	Foreign-exchange shortage continues.	Malawi
	Morocco	Real GDP growth officially estimated at 6.3% last year, versus 3.1% in 1979.	Nov.	+ 10%	15.3*	788	Feb.	83	— 80%	0.3	405	Phosphate rock prices averaged $49.50/ton in 1Q 1981, vs. $47 in IVQ 1980.	Nov.	+ 10%	Jan.	+ 6%	.2125	— 18%	Arab Monetary Fund to lend $59 million for payments support.	Morocco
	Nigeria	Two loans totaling $537 million to cover financing of Ajaokuta Steel Complex signed.	Jan.	+ 30%	61.0	760	Feb.	9,164	+ 47%	9.5	0	Oil price cut possible; output likely to stay at current level.	Mar. '80	+ 12%	Aug.	+ 15%	1.7850	0	Money supply growth to be held to 19% in 1981.	Nigeria
	Sierra Leone	IMF approves $200-million loan to support economic program; import and price controls strengthened.	n. a.	—	0.9	262	Feb.	18	— 62%	0.7	22	Higher mining-sector earnings offset by fall in tourist receipts.	Feb.	+ 11%	Dec.	+ 20%	.9925	+ 4%	Foreign-exchange shortage severe.	Sierra Leone
	South Africa	Consumer prices rising at 18% annual rate, fueled by food price increases.	Feb.	+ 12%	80.2	2,725	Mar.	1,196	+ 84%	0.7	0	First-quarter trade surplus was $742 million, versus $1.7 billion year ago.	Feb.	+ 16%	Jan.	+ 46%	1.2090	— 4%	Larger deficit will boost official claims on capital market.	South Africa
	Sudan	Port Sudan-Khartoum fuel pipeline should become fully operational this year.	Aug.	+ 41%	5.8	320	Mar.	34	— 54%	0.3	320	External-account worsening continues; exports average one-third imports.	Dec.	+ 13%	Feb.	+ 39%	2.0175	+ 1%	U.S. aid to rise to $151 million in FY 1981-82.	Sudan
	Tunisia	Rising public-sector budget outlays spur continued expansion of economic activity.	Dec.	+ 12%	7.1*	1,135	Mar.	531	— 2%	2.0	0	Trade gap with EEC was $861 million in 1980, versus $572 million in 1979.	Dec.	+ 10%	Jan.	+ 22%	2.1150	— 15%	Kuwait Fund lends $40 million for development projects.	Tunisia
Middle East	Iran	Forecast sharp rise in budget outlays to $44 billion in FY 1981/82; previous fiscal gap put at $11 billion.	Jan.	— 68%	n. a.	—	June '80	15,478	+ 41%	n. a.	0	Oil output averaged 1.4 million bpd in Feb. vs. 1.2 million bpd in Dec.-Jan.	Jan.	+ 25%	Mar.	+ 32%	n. a.	—	Money supply growth accelerating.	Iran
	Iraq	State budget estimates put 1981 revenues at $64.8 billion and expenditures at $65.9 billion.	Jan.	— 4%	n. a.	—	n. a.	—	—	—	0	Oil output averaged 700,000 bpd in Feb., up 27% from Jan.	n. a.	—	—	—	3.41	+ 1%	Credit generally available.	Iraq
	Kuwait	Official ban imposed on domestic establishment of new investment firms by the private sector.	Jan.	- 3%	23.3**	18,330	Feb.	3,713†	+ 41%	7.1	0	Agreement with BP, Shell, and Gulf on oil supply; lower volume, no premiums.	Dec.	+ 9%	Jan.	+ 12%	3.62	— 2%	Claims on private sector continue to expand.	Kuwait
	Saudi Arabia	Actual budget outlays a record $56.2 billion in FY 1979/80, 17.7% greater than allocated.	Jan.	+ 57%	92.0**	16,725	Mar.	29,183†	+ 61%	12.3	0	Price of war-relief crude of 550-600,000 bpd cut to $34 per barrel.	Dec.	+ 2%	Oct.	+ 14%	.2966	— 1%	Saudis agree to lend IMF $9.8 billion over 2 years.	Saudi Arabia
	United Arab Emirates	Federal budget outlays for 1981 projected at $6.5 billion, up 60% from 1980 allocation.	Feb.	+ 21%	16.0*	19,275	Mar.	2,329†	+ 115%	3.3	0	Oil earnings estimated at $18.5 billion last year, up 40% from 1979.	n. a.	—	Jan.	+ 17%	.2735	+ 1%	Bank claims on private sector up 21% in 1980.	United Arab Emirates

*1979 **FY 1979/80 †Excluding state reserves

World Interest Rates

market rates of May 6, 1981; bond yields as of May 1, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	14.00 penalty large banks 18.00	17.60	12.00	14.00	9.50	7.50	19.00 penalty rate 22.00	9.00	4.00	6.25
Day-to-Day Money	18.50 May 7	17.50	12.50	13.80	12.25	12.00	19.75	10.25	8.00	7.3125
Treasury Bills 91-day, Middle Rates	16.50	18.00	11.3125	17.00	13.70 one-year	n. a.	17.50 85-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	17.00 finance paper	18.40 finance paper 15% tax w/h	11.26	13.90 Certified	13.75 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	17.65	18.45 15% tax w/h	12.5625	13.90 Certified	not traded	9.90	21.80	no market	n. a.	no market
Government Bonds Long-term, new and old issues, average yield	14.04	15.75	13.59	11.76 20% tax w/h	14.36	10.05	18.51	11.49	5.48	8.00
Industrial Bonds prime, long-term, new and old issues, average yield	15.05 Aa Industrials	15.625	14.51	18.08	15.39	10.55	19.11	12.29	6.28	7.07
Bank Short-Term Rate to Best Borrowers (prime rate)	19.00	18.50	13.00	19.25	14.35	13.75	22.50 ⅛ quar'ly fee on outstdng.	12.50	8.00	6.75
Bank Time Deposits 3-month	17.875 Cert. of Dep.	17.75	12.375	16.70	13.625	13.45	10.75	12.125 large deposits	9.875 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	19.0625	no market	12.8125	no market	15.00	13.1875	no market	12.00	9.6875	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8334	2.1175	.02721	.1878	.4425	.000888	.3988	.4842	.004617
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.75 *P*	7.00 *P*	.50 *P*	4.50 *P*	4.00 *P*	1.00 *D*	7.00 *P*	9.375 *P*	11.00 *P*

Eurodollar Deposits
(London, interbank, bid)
May 7

7-day	19.25
1-month	19.8125
3-month	19.75
6-month	19.1875

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−7.56
U.S.-Canada Treasury Bills	−1.24
U.S.-Canada Finance Co. Paper	−1.90
Eurodollars-U.K. Local Auth. Deposits	n. a.

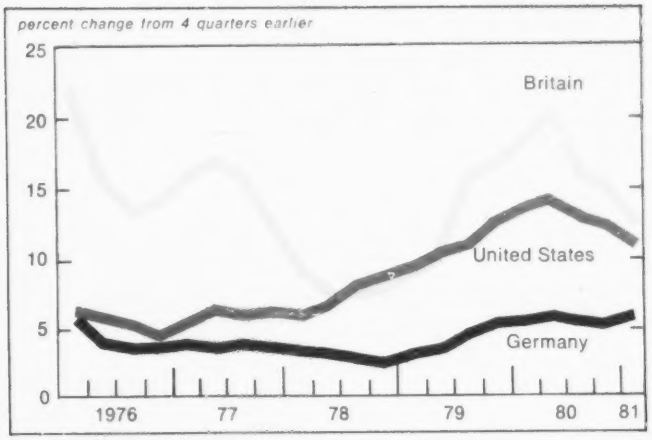
Eurobonds
(average yield on recent straight debt issues)

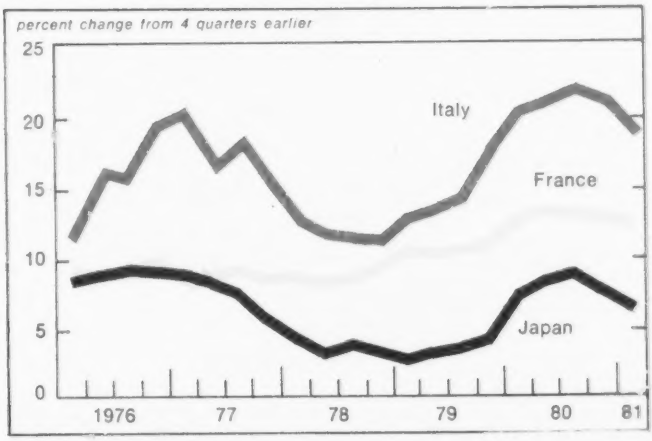
U.S. Dollar Bonds	
7 yrs. and under	15.625
Over 7 yrs.	14.75
DM Bonds	
7 yrs. and under	10.75
Over 7 yrs.	10.625

Gold Price
London afternoon fixing
482.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Consumer price trends in major industrial countries





Japanese Economic Outlook

The pace of inflation-adjusted economic growth in Japan slowed to 4.2% last year from 5.6% in 1979, owing largely to the sharp rise in oil prices and a restrictive monetary policy. The forces contributing the most to growth were private plant and equipment investment and net exports; private consumption and residential housing investment were quite weak. The oil price rises contributed to a more-than-doubling of the consumer price inflation rate to 8% and to a widening in the current-account deficit to $10.8 billion from $8.8 billion in 1979.

The domestic economy has remained sluggish so far this year, but economic activity is expected to pick up in the third quarter. For 1981 as a whole, real economic growth of 3.7% is projected. Progress on the inflation front should be substantial, with the rate of consumer price increase likely to ease to 5%. And on the external front, the current-account gap is projected to narrow to less than $6 billion.

A weak economy in 1980

For Japan, as well as for the rest of the non-oil exporting world, 1980 was a year of adjustment to the second wave of huge oil price hikes. The price increases of 1979-80—combined with the restrictive monetary policy aimed at dampening their inflationary impact—slowed Japanese economic activity last year. The major source of weakness was private consumption, as the burden of the terms-of-trade deterioration was borne primarily by labor in the form of moderate wage increases. The annual average wage settlement of 6.9% was outpaced by consumer price inflation, and with little if any increase in real disposable income, consumer spending rose by just 1.3% in real terms. The only bright spots were private plant and equipment investment and net exports. The sharp increase in oil prices induced businesses to undertake investment aimed at energy-saving and rationalization, despite the economic slowdown. Consequently, investment in plant and equipment increased 6.4% in real terms. Net exports, however, provided the main stimulus to growth, contributing 3.6% of the 4.2% real GNP increase.

Japan's rate of inflation, although worrisome early in 1980, moderated significantly over the course of the year, owing to the relatively restrictive monetary policy pursued for much of 1980. On a year-over-year basis, wholesale price inflation peaked at 24% in April and consumer price inflation peaked at 8.7% in September. For the full year, average wholesale prices rose 17.8%, with consumer prices rising 8%. But on a December-to-December basis, the wholesale price index increased only 9.6% while the consumer price index advanced 7.1%.

Although Japan's current-account deficit widened to just under $11 billion last year, the shortfall narrowed as the year progressed and was nearly eliminated by yearend. For the full year, exports rose 25.1% in value terms, while imports advanced 25.3%. The volume of crude oil imports fell 9.5%, but the value of petroleum and petroleum-product imports soared 52%. On trade account, the surplus expanded marginally to $2.1 billion from $1.8 billion in 1979.

The long-term capital account made a remarkable turnaround last year, registering a surplus of $1.8 billion—in contrast to a deficit of $12.6 billion in 1979. The reversal is attributed to a surge in investment from overseas, mainly from the Middle East. The large-scale foreign purchases of Japanese financial assets, together with the steady improvement in the current account, also had the effect of bolstering the yen on foreign-exchange markets last year.

Government policies fine-tuned

As inflation showed signs of easing and as the domestic economic weakness became increasingly apparent in 1980, the Japanese government took steps to spur economic activity, with emphasis on monetary policy. Beginning in August, the central bank discount rate was progressively lowered from its peak of 9% to 7.25% by yearend. Window guidance was also relaxed. Nevertheless, the domestic economy remained surprisingly weak; real GNP advanced at a seasonally adjusted annual rate of only 2% in the final quarter of 1980. As a result, in March 1981 additional measures were taken. The Bank of Japan cut its discount rate to 6.25%, lowered reserve requirements, and, in effect, abolished restrictions on commercial bank lending for the second quarter of 1981. Interest rates on deposits were also cut.

Given the weakness of the domestic economy and the favorable outlook for inflation, a further cut in the discount rate is likely in 1981, and window guidance will probably remain lenient. However, the Bank of Japan, concerned by the prospect of large capital outflows in response to higher interest rates overseas, has left the door open to a tightening of monetary policy should external considerations warrant it.

Modestly stimulative fiscal measures have accompanied the relaxation in monetary policy. Fiscal measures announced in March 1981—which are an extension of those adopted in September 1980—are designed to aid small and medium-sized businesses, boost housing construction, and accelerate public-works spending. But fiscal stimulation has been limited by the government's desire to reduce the budget deficit and thereby cut back on the issue of national bonds for

Japanese Economic Outlook *(continued from page 7)*

deficit financing. Indeed, the fiscal 1981 budget calls for the rise in government spending to be held to 9.9%, the lowest rate of increase in 22 years. The budget deficit is set to narrow to 26.2% of total expenditure, with an increase in revenues resulting from fiscal drag and a boost in indirect taxes and in the corporate income-tax rate.

With cumulative government debt soaring, Japan's Prime Minister Suzuki has pledged to reduce the volume of new bond flotations to zero by 1985. Given the reluctance to adopt major new tax measures, this suggests low growth in public expenditure for the next several years.

Capital and exchange controls relaxed

Japan's new Foreign Exchange and Foreign Trade Control Law went into effect on December 1, 1980. Whereas previously all external capital transactions were restricted in principle, under the new law all transactions in trade, foreign exchange, and capital—in principle at least—will be free. Specifically, Japanese residents will be permitted to hold unlimited foreign-currency deposits with domestic banks, nonresidents will generally be allowed to hold shares of domestic companies without restriction, and Japanese lending in yen and dollars will no longer be constrained.

Possible control could still be exerted through administrative guidance, and the monetary authorities have reserved the right to take more direct action in emergencies. Thus, it remains to be seen to what extent the government will act to restrict capital flows in the event of excessive exchange-rate fluctuations or balance-of-payments difficulties. Nonetheless, a new discount mechanism announced as part of the March economic package suggests that the monetary authorities will rely increasingly on interest rates as opposed to direct controls to affect capital flows. The new law is expected to hasten the decontrol of domestic interest rates and promote the alignment of domestic and foreign interest rates through interest arbitrage.

The 1981 outlook: growth rebound in second half

Figures on real growth in the first quarter of 1981 are not yet available, but there is little indication of much improvement in the economy. Housing starts remain extremely low and corporate bankruptcies continue high. And despite severe production cutbacks by manufacturers, inventories remain bloated because of the continued sluggishness of personal consumption and housing. It does appear, however, that the October-March period will prove to have been the low point in the current growth recession.

The government's business-boosting measures are not expected to accelerate the economy's recovery to any great degree. Inventory adjustment will not be completed before midyear, and consumer spending is unlikely to strengthen until after the spring wage increases. Thus, economic activity is not expected to pick up strongly until the third quarter of 1981. For the year as a whole, real GNP appears likely to increase by 3.7%, on a year-over-year basis.

In contrast to 1980, the strength of the economy in 1981 will come from domestic demand. This spring's wage negotiations are expected to result in an average wage settlement of about 7.5%, and as real disposable income rises with a moderation in inflation, consumer spending in real terms should grow about 4%. Despite the increase in corporate tax rates and a deterioration in corporate profits during the first half of the year, business investment in plant and equipment is expected to remain firm.

Government spending on public works and other projects may bolster business during the first part of the year, but for 1981 as a whole, government expenditures will not expand much in real terms. Although imports will be sluggish until economic activity picks up in the second half, net exports will contribute considerably less to growth in 1981 since the pace of export expansion will decelerate with the slump in the world economy and increasing protectionism abroad.

The rate of inflation has continued to moderate during the first few months of this year and is expected to continue doing so through midyear. In the second half, inflationary pressures may heat up in response to a relaxation of monetary policy. For 1981 as a whole, consumer price inflation is forecast to average about 5% on a year-over-year basis—barring an unexpectedly large rise in oil prices.

Finally, the external accounts should show significant improvement this year. The trade surplus is forecast to swell to $8.6 billion, paced by 16% growth in exports and an 11% rise in imports, and the current-account deficit is projected to narrow to $5.9 billion. The improvement on both accounts, however, will prove greater in the first half of 1981, before the domestic recovery has a chance to boost imports. Foreign investment in Japanese stocks and bonds, which slowed toward the end of 1980, accelerated once again in the early part of 1981. And interest is likely to remain high on the part of European and U.S. pension and trust funds as well as such OPEC nations as Saudi Arabia, which recognize Japanese securities as prime candidates for the diversification of their portfolios.

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